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Long-run Ranges Briefing
Donald L. Kohn

The Committee's decision about its monetary objectives for 1990, may be subject to a bit more scrutiny than in recent years. The public discussion and debate of the Federal Reserve's price stability objective and the costs of achieving it have heightened interest in the Committee's medium-term strategy. For example, the Senate Banking Committee, in its letter of invitation to the Chairman for his forthcoming testimony, posed questions about how our annual targets fit into our plans to achieve price stability, and about the implications of this objective for growth and resource utilization.

The question of costs was discussed extensively at the last meeting, and is raised again in the context of longer-term strategies, which I will be getting to in a minute. The relationship of annual money targets to long-term goals is, unfortunately, complex. Year-to-year growth rates in money may not convey, in a way that can be easily understood, the underlying objective of monetary policy. This can be seen quite clearly in the staff forecasts of money and debt growth rates for 1990 consistent with the greenbook forecast, which are shown in the right hand column of the table on page 12 of the bluebook. Although that forecast involves some restraint on underlying inflation pressures, M2 growth is expected to accelerate from the 4-1/4 to 5-1/4 percent range of the last three years to around 6-1/2 percent this year. The faster growth of M2 in the forecast occurs because of a judgment that underlying demands for goods and services have been sufficiently damped,

largely by past monetary restraint, that price pressures can be held in check without significant further upward movement of interest rates in 1990. The forces imparting an upward bias to money velocity in the past several years will no longer be operating, and money growth will be more in line with spending. In fact, the staff expects a small decrease in velocity this year, of less than 1 percent, owing to the lagged effects of declining interest rates over the second half of 1989. I might note that the risks around the M2 projection are probably more heavily weighted toward somewhat less growth than somewhat more. The shortfall would occur if deposit offering rates are reduced more than expected--by banks flooded with thrift core deposits, and by thrifts with renewed access to RTC funds to paydown high-cost liabilities.

With respect to M3 and debt, we see the opposite pattern developing--that is, a damping of growth that is out of proportion to the policy restraint assumed in the forecast. For M3, this reflects the effects of the working out of the thrift situation, involving a major restructuring of mortgage flows in credit markets, with a much lower than usual fraction of mortgage assets ending up in the portfolios of depository institutions and financed with M3. We are projecting only 4 percent M3 growth this year, extending the atypical relationship of this aggregate to M2 and spending that developed in the second half of 1989 when the thrift industry began to shrink in earnest. Debt is expected to decelerate from 8 to 7 percent in 1990. Nearly half of this slowdown is attributable to an assumed decrease in debt issuance to retire corporate equity, rather than a contraction of underlying finance available to support spending.

The complex relationship of yearly money growth to developments in the economy and inflation also can be seen in the alternative policy simulations shown on page 8 of the bluebook. Even in the tighter strategy II, M2 running a little above its average pace of recent years is consistent with a drop in inflation to 2 percent by 1994. This pattern partly reflects a relatively stable path for nominal GNP, with output depressed initially and picking up later, while prices slow with a lag. In addition, however, it is a function of declines in interest rates and velocity as inflation moderates, so that the same money growth supports slower nominal spending in the transition period to price stability. This is an aspect of the so-called re-entry problem, in which, to avoid precipitating deflation, M2 must be allowed to expand faster than its long-run equilibrium growth rate for a time as nominal and real interest rates fall when price stability is approached. To the extent the drop in interest rates since the middle of last year reflected a decrease in inflation expectations, so that restraint in terms of real interest rates can be maintained at lower nominal interest rates, stronger M2 growth in 1990 can be seen as a taste of the kinds of counter-intuitive money growth paths that may be associated with attaining price stability.

A few other points are worth noting about the simulations. First, they start from the presumption that the unemployment rate has to rise from current levels to keep inflation from accelerating in an underlying sense. This can be seen most clearly in the easier strategy III, in which, despite economic growth below potential and a small rise in the unemployment rate this year, inflation is little changed in later

years aside from the effects of dollar depreciation through 1991. To relieve pressure on resource use sufficiently to damp inflation probably requires some upward movement in real interest rates, though the size of the increase is not large, at least in the baseline.

Second, because of the starting point, and also the implied short-run trade-offs in the model between resource utilization and inflation, a sustained period of subpar growth would be needed over the next few years to make substantial progress in curbing inflation, as under the tighter strategy II. However, the model makes no allowance for changes in Federal Reserve credibility as markets measure our actions against our rhetoric. Maintaining a taut policy under this strategy, even as the unemployment rate rises, might induce business and workers, as well as financial market participants, to give greater weight to our stated long-run objective, speeding the reduction in inflation expectations. Thus, even though none of the simulations presented show price stability in the 5-year horizon, the resource utilization path of strategy II might actually have a good chance of closely approaching price stability at or just beyond 1994.

Although money growth rates do not translate easily into, say, inflation intentions, the choice of objectives for 1990 can convey something about the Committee's medium-term strategies and priorities. With this in mind, and with an eye to the current outlook for growth of the various aggregates, the staff presented on page 12 of the bluebook, not only the tentative ranges, but also several alternatives.

When the Committee adopted its tentative ranges last July, it carried over the existing 1989 ranges into 1990. These ranges could be

adopted as final. Staff projections for the three aggregates lie within the tentative ranges, and it seems likely that these ranges also would support the path for the economy and prices most Committee members envision as well, since the central tendency of your forecasts is similar to the staff projection.

However, one reason the Committee simply carried over the 1989 ranges was because of the uncertainties in the financial outlook, associated in part with the workout of the thrift situation. These uncertainties seem to be resolving themselves in ways that suggest adjusting the ranges, at least for M3 and debt. To recognize the structural shifts brought about by greater thrift shrinkage and reduced equity retirements than was contemplated in July, all the alternatives have in common lower M3 and debt ranges. Some reduction in these ranges would not connote a "tighter" policy than contemplated in July or than would be consistent with modest restraint on inflation pressures, given these structural shifts. In this context, the staff considered alternative II, which reduces the M3 and debt ranges, but retains the M2 range, to be roughly equivalent, in a policy sense, to the tentative ranges. Indeed, even greater reductions would be needed to center the M3 and debt ranges around the staff outlook, but such reductions were not proposed partly because of the possibility that the ranges might have to be raised in future years after special effects abated, and the difficulties such a reversal might raise in public perception of monetary policy intentions. The alternative II ranges would seem to be balanced in a way that suggested more scope for a tightening of policy than for

an easing, with the range for M2, the most interest sensitive of the targeted aggregates, providing the principal reading in that regard.

Although an M2 range of 3 to 7 percent may be consistent with staff and FOMC projections, it probably would not encompass the administration's economic forecast. The 7 percent nominal GNP for 1990 and falling interest rates of that forecast suggest M2 growth on the order of 8 percent in 1990. The administration has addressed this potential inconsistency in the CEA report released yesterday. This report is generally very supportive of the conduct of monetary policy and the Committee's objective of price stability. But it acknowledges that M2 could exceed its tentative range for 1990, and suggests two approaches: raising the range, or simply allowing an overshoot to develop, which would be explained ex post as an artifact of declining velocity. The Humphrey-Hawkins report also is required to address the relationship of the FOMC's ranges and the administration's forecast. The inconsistency of the M2 range with the administration forecast might connote something a bit more fundamental than a disagreement over velocity, since it arises from more rapid income growth than the FOMC's central tendency, as well as from the assumed drop in rates. The rate decline could be attributed to the tighter fiscal policy assumed by the administration, but higher real and nominal income growth might be considered less conducive to inflation restraint than the Committee might believe desirable.

Alternative I contains a higher M2 range, should the Committee wish to allow for significantly greater income growth than in the staff or FOMC forecasts, or for a drop in interest rates. Faster income

growth might be considered appropriate if the Committee wanted to key policy to maintaining the expansion of the economy close to the rate of growth of its potential in coming years. Room for more rapid M2 growth might also be appropriate if the Committee saw the risks as greater on the side of a shortfall in aggregate demand. Actions to sustain growth under such circumstances by reducing interest rates might soon lead to M2 growth above the upper limit of its tentative range. The increase in the M2 range might be seen as connoting more attention to and concern about the performance of the real economy on the part of the Federal Reserve. However, given the expectations for M3 and debt growth, the ranges for these aggregates still could be reduced without compromising the intent of alternative I.

On the other hand, if the tentative range for M2 were adopted, as in alternative II, it would be the first time in four years that the M2 range had not been reduced, and might be seen as casting doubt about the Federal Reserve's commitment to its price stability objective. A reduction in the M2 range, as under alternative III, would underline that commitment, and imply that the Federal Reserve was more concerned about risks of inflation accelerating than of economic expansion falling a little short of expectations. With M2 already running along the upper end of this range, adoption of alternative III would seem to imply a prompt response to tendencies for this aggregate to run over its range, as might occur if price pressures in the economy turned out to be a little stronger than expected. It would also imply more limited responses, in the form of reducing interest rates, to any tendency for economic activity to fall short of expectations. Presumably the range

would not be allowed to constrain actions to cushion a major shortfall in demand and downturn in the economy, which might require an overshoot of the upper bounds of all the alternatives. But the lower range may imply the desire to delay a reaction to data suggesting softness in the economy in order to gauge the extent of the weakness, and a willingness to allow relatively minor shortfalls in demand to show through into slower growth initially and ultimately into a reduced rate of price increase.

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Short-Run Policy Briefing
Donald L. Kohn

I will be relatively brief Mr. Chairman, partly because you've heard enough from me today, but also because yesterday's discussion of bond yields covered much of the ground I was prepared to go over. This won't deter me entirely, however; the issue of what has been driving long-term rates is of sufficient import for the stance of monetary policy that I thought it might be useful to sum up the arguments and to add some thoughts on possible implications of other cross currents recently evident in financial markets.

With regard to the bond yields--first, I think it was generally agreed that the rise in bond yields was largely an increase in real interest rates. Inflation prospects may be a little worse over the near-term, and the outlook for a significant downward adjustment in longer-term inflation rates probably looks less likely to those who had thought the economy was slipping into recession. Nonetheless, it seems farfetched that developments over the intermeeting period would have caused long-term inflation expectations to be revised up by more than 1/2 percentage point.

Second, if at least some of the rise in real rates can be seen as an increase in equilibrium real rates, then it might not imply much more restrictiveness. To an extent, this can be inferred from the yield curve. The slight upward slope of that curve is consistent, taking into account usual liquidity premiums, with market expectations that economic

expansion will be sustained at something like the current level of short-term rates, without any significant moderation of inflation.

A major factor behind the market's rethinking appears to have been the incoming data on the U.S. economy, which presented much more of a mixed picture than had been built into the earlier prevailing expectations of further Federal Reserve easing. Apparently, previous levels of real rates were now seen to be less restrictive than had been thought. Increases in foreign rates may also have played a role, though one needs to be careful in interpreting the simultaneous increases in rates in industrial countries. To the extent the rise in worldwide interest rates represented a response to perceptions of newly opening opportunities in Eastern Europe, or if the upward movements of rates abroad resulted from a generally stronger demands on their economies, the equilibrium real rate in the US also would tend to rise. The expansion of those economies will feed back onto the US economy through, for example, greater demands for our exports, supporting growth here at the higher real rates.

But other factors may have been pushing up bond yields as well, with less benign implications for the United States. For one, some of the increase may have involved market overshooting, arising perhaps from a rush of sales when investors decided simultaneously to lighten portfolios, or even from one of those mysterious Japanese accounting rule changes. A suspicion that such transitory factors may have been involved lay behind the hint in the bluebook that bond yields could edge down once the Treasury refunding is over. In addition, our rates could be reacting to the prospects for tighter monetary policy abroad, though

in the past this generally has shown through mainly in exchange rate changes rather than interest rates, and there has been little confirming evidence in short-term rates abroad. Or, uncertainty may have increased, driving investors into shorter-term instruments, or even into gold. That these additional uncertainties are emanating at least as much from Japan and eastern Europe as from the United States, could be another explanation behind the the worldwide nature of the rise in bond yields.

On balance, it would appear that most of the increase in bond yields might be attributable to increases in actual or perceived equilibrium real rates, and to a lesser extent to higher inflation expectations. But some part also may represent a tightening of conditions that could damp demand in certain sectors, perhaps more than now expected by the market. Other developments in financial markets have also worked in this direction. The drop in the stock market has reinforced the sense of higher capital costs to businesses and has reduced the wealth of share holders. And the evidence that lenders are adopting a more cautious attitude, however welcome from a supervisory perspective, may be raising the cost and reducing the availiblility of credit for some private borrowers. These borrowers are, in effect, facing even greater increases in real rates than suggested by tracking rates in the Treasury, or even private securities markets.

On the other side of the ledger is the depreciation of the dollar against major currencies, except the yen. Whatever the reason for its behavior, the drop in the dollar would make US goods more competitive in international markets, stimulating output and import price increases. It seems likely that the decline in the dollar contributed

to the rise in US bond yields, through revisions to both expected real rates and inflation. If this is an important channel for the transmission of interest rates around the world, it suggests that the mechanism for such a transmission itself carries somewhat offsetting effects for the economy--both for the countries whose currencies are depreciating and those whose currencies are appreciating.

Money growth, after slowing in January, is expected to rebound over the balance of the quarter. The M2 growth in the staff projection would imply expansion in the first half of 1990 close to the upper bound of the long-run range you adopted today. Moreover, such growth would still keep P* close to the projected price level, reinforcing the notion that the stance of monetary policy implied little near-term downward impetus to price pressures.

Finally, although inflation concerns may not account for much of the rise in bond yields, they have worsened recently, as was evident from the consumer surveys discussed yesterday. Under these conditions, restraint on the pace of economic activity, as might arise in part from some of the bond and credit market developments just discussed, may be necessary to prevent temporary increases in food and fuel prices from becoming embedded in long-term price expectations.

In light of the divergent signals given by these various factors, the Committee might want to extend the period of stable operating policy, as under alternative B, awaiting further developments that would point more clearly to the need for policy adjustment. If the Committee were to view the evidence as suggesting the need for a further slight easing of policy at this time, it could well be that such an easing

would show through primarily in a depreciation of the dollar, and very little in a decline in nominal bond yields, though real long-term rates might decrease. As such it would buoy demand in the United States, if that were the Committee's intent. This particular channelling of policy effects would be as much a function of the tender nature of inflation expectations at this time as it would be of international financial interdependencies.